

ARTICLES

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Investing in Eastern Europe Through an Austrian Holding Company**

United States corporations are increasingly interested in making direct investments in Eastern European countries. The likelihood of expanding opportunities for such investments in the near future focuses attention on how such investments can be structured to produce the most favorable U.S. and foreign tax treatment. Many of these investments are likely to be made on a joint venture¹ basis with equity owned in part by the U.S. investing corporation and in part by local interests. In addition, the establishment of wholly owned subsidiaries will be feasible in a number of these countries.

One possibility to be considered by a U.S. corporation making an investment in a business enterprise in one of the Eastern European countries is having the investment held, not by the U.S. corporation itself, but by a wholly owned

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**The manuscript of this article was finished in November 1991. Thus, new legislation, in particular in the Eastern European countries, might have been enacted between then and the date of publication. The author wishes to emphasize that most of the information on East European law appearing in this article had to be derived from secondary sources since complete translations of statutes hardly exist. Precise citations regarding East European law therefore could for the most part not be supplied.

1. In common parlance, the phrase joint venture refers to any business enterprise in which the equity is divided between two or more participants; it does not imply any particular form of business organization. For purposes of this article, however, the phrase will generally refer to enterprises organized as companies enjoying limited liability. In a few countries of Eastern Europe a joint venture can also be organized in the form of a partnership. The partnership form, however, is not commonly used.

holding company organized under the laws of Austria. Under certain circumstances, the use of such a holding company is likely to result in substantial tax savings.

This article discusses the foreign and U.S. tax aspects of the use by a U.S. corporation of a wholly owned Austrian holding company to effect a direct investment in a number of Eastern European countries. It begins, after a brief overview, with a general summary of certain investment conditions and the current tax rates in the Eastern European countries of Bulgaria, Czechoslovakia, Hungary, Poland, and Romania.² An examination is then provided of various aspects of Austrian corporate and tax law applicable to holding companies organized under Austrian law. Thereafter follows a comparison of the use of an Austrian company to hold direct investments in Eastern Europe with the use of a holding company organized under the laws of a number of other countries frequently used for this purpose, including Switzerland, the Netherlands, and Cyprus. Finally, the article provides a review of the U.S. tax rules relevant to the possible use of a foreign holding company.

I. Overview

Under the participation privilege exemption of the Austrian corporate tax law, dividends received by an Austrian holding company with respect to an equity interest of at least 25 percent of the outstanding shares of a foreign company are exempt from Austrian corporate tax.³ In addition, Austria has entered into a number of treaties with Eastern European countries to eliminate double taxation. Under the treaties the withholding taxes that may be imposed by the source country on dividends, interest, and royalties paid by a local corporation to an Austrian holding corporation are lower than the withholding tax rates that would apply to such payments made directly to a U.S. corporation. If and when dividends are paid by the Austrian holding company to the U.S. parent, a 5 percent Austrian withholding tax is imposed. This represents an additional tax cost of the holding company structure to the extent that such dividends are paid. However, in some cases the reduction in withholding tax in the Eastern European country mandated by such country's treaty with Austria is greater than the 5 percent Austrian withholding tax. These factors suggest that significant tax savings may be achievable in some cases by interposing an Austrian holding company between a U.S. investing corporation and the Eastern European operating corporation that is the target of the investment.

For example, if a U.S. corporation acquired directly a 51 percent stock interest in a Czechoslovakian corporation, dividends paid by the latter to its U.S. parent

2. Yugoslavia and the former Soviet Union are not dealt with in this article since the recent upheavals in these countries render it largely impossible to make statements about prevailing laws with any degree of precision.

3. Certain other prerequisites to the exemption are discussed below.

corporation would be subject to a Czech withholding tax of 25 percent. However, if the stock is owned by an Austrian holding company, under the terms of the Austrian-Czechoslovakian Tax Treaty, the Czech dividend withholding tax would be limited to 10 percent. The dividend would also be exempt from Austrian corporate tax. The reduction in Czech withholding tax would more than outweigh the 5 percent Austrian withholding tax on dividends paid by the Austrian holding company to its U.S. parent.

The potential advantage of interposing an Austrian holding company would be eliminated if and when the U.S. enters into tax treaties with each of the Eastern European countries that reduce withholding tax rates in the source country on dividends, interest, and royalties to the levels that apply under the existing Austrian tax treaties with these countries.

II. General Economic Situation and Joint Venture Laws in Eastern European Countries

In view of the recent dramatic developments in the former Eastern Bloc countries, a few comments may be offered on the general business environment in this part of the world, and more specifically on some special aspects of real estate and corporate law, before addressing certain aspects of the pertinent Eastern European tax laws.

A. GENERAL BUSINESS ENVIRONMENT

Some Eastern European countries, most notably Czechoslovakia and Hungary, have relatively developed economies (including skilled labor, infrastructure, and industrial tradition), in sharp contrast to others, such as Bulgaria and Romania. Nevertheless, the economic climate in all the countries being surveyed is typified by the need for western capital, technology, and know-how. The fledgling democracies of Eastern Europe are anxious to emulate western standards and hope to do so particularly by encouraging investors from the west to form joint ventures with local enterprises, which would facilitate a transfer of capital, technology, and entrepreneurial spirit. Consequently, new legislation aimed at attracting western investment, primarily by way of joint ventures, but also in various other forms, has been passed in all countries under discussion. Apart from such "external" measures, privatization programs are under way, especially in Hungary and Czechoslovakia, and governments are trying diligently to enact new laws, such as corporation and tax codes, necessitated by the transition from a controlled to a market economy. Laws that only recently have been adopted are often revised again very quickly, which adds to the difficulty of western investors seeking to implement their strategic business decisions. In addition, principally as a result of the language barrier, western attorneys face the problem of "accessibility" of new legislation, while most domestic lawyers are poorly trained as well as inexperienced in handling complicated transactions.

Another significant problem is the absence of western-type accounting principles. Under the prior regimes, reasonably informative financial statements did not exist because the distinction between equity capital and debt capital was either unknown or simply not utilized, and assets were frequently revalued in an unprincipled fashion when necessary in the light of such factors as the urgent need to meet five-year-plan targets. Legislative revisions will gradually remedy this problem. For the time being, western investors might overcome some difficulties in this regard through specifically tailored provisions in the joint venture agreement governing accounting treatment if they are unable to reach an agreement that generally accepted international accounting principles will apply.

Like many third world countries, Eastern European countries have attempted to encourage the desired level of inward investment by entering into treaties with western countries on the protection of investment. Austria, like some other industrialized countries, has concluded such treaties with Hungary, Poland, and Romania.⁴ A treaty with Czechoslovakia was recently entered into; another one with Bulgaria is currently under negotiation. Apart from bilateral treaties, the domestic laws of a fair number of Eastern European countries already accord a certain degree of protection against nationalization and expropriation.⁵

B. REAL ESTATE LAW

A highly visible tenet of public policy in all countries of Eastern Europe is to protect the country from being "sold out" to and dominated by the western economies. In this respect, real estate is a particularly sensitive issue. In Bulgaria, for example, joint ventures are not accorded the right to acquire title to real property. They are generally relegated to leaseholds that may be obtained for a period of up to seven years.

In Czechoslovakia and Hungary foreigners generally may not purchase real property, though it is possible to set up a wholly foreign-owned corporation that, in turn, is permitted to acquire such property. However, Czechoslovakia has an exception to this rule: a foreigner is able to acquire title to real estate directly if the purchase takes place in conjunction with the privatization of enterprises currently being implemented. Polish law recognizes privately owned real property in general, but joint ventures need permission from the Ministry of Internal Affairs to acquire real estate if the domestic interest is less than 50 percent. In Romania foreign investors are in general prohibited from owning land.

C. CORPORATE LAW

In the majority of the countries being reviewed the establishment of a joint venture, or where possible, the setting up of a 100 percent foreign-owned cor-

4. BGBl 339/1989 (Hungary); BGBl 473/1989 (Poland); BGBl 553/1977 (Romania).

5. See, e.g., Czech Act on Companies with Foreign Participation § 22.

poration is still subject to approval by one or more authorities, although a tendency towards further liberalization in this regard undoubtedly exists. Apart from approval requirements, if any, the usual practice is that a company (joint venture or otherwise) takes on legal existence only after it applies for and is granted registration by a court.

1. *Bulgaria*

Bulgarian law allows foreign investors to acquire equity in, or set up wholly owned, limited and unlimited liability companies as well as corporations without obtaining approval of the authorities. However, the Council of Ministers may determine on a case-by-case basis that the establishment of limited and unlimited liability companies more than 49 percent owned by foreigners, and corporations more than 20 percent owned by foreigners, shall be subject to approval.⁶ All companies and corporations have to be registered with the Industry and Trade Chamber.

2. *Czechoslovakia*

As of April 15, 1991, Czechoslovakia abolished the previously existing general requirement that official permission be obtained for the establishment of joint ventures. Now, the rule is that all companies (wholly foreign-owned jointly by foreigners and Czech interests, and wholly owned by Czechs) may be established without the consent of any authority merely by entry in the company register at the competent district court. The only exception is the establishment of companies in which another company, which is directly or indirectly under public administration, will have an interest. In such a case approval by the Government of the Czech Republic or the Government of the Slovak Republic, depending on the location of the enterprise to be established, is mandated due to the need to effect the transformation of state owned into privately owned property under the privatization program currently being implemented.⁷

3. *Hungary*

Similarly, the setting up of a joint venture in Hungary requires generally nothing more than registration with the competent commercial court. This applies as well to affiliates exclusively owned by a foreign investing entity. Only if

6. Foreign legal and physical persons may carry on economic activities according to the provisions of the Decree No. 56/1989; the Regulations of Feb. 15, 1989 for the Application of Decree No. 56/1989; and the Act on the Amendment of the Decree No. 56/1989 of Dec. 12, 1990. The introduction of new legislation is currently being discussed.

7. The primary legislative bases for business activities of foreigners and joint ventures are the Act on Economic Relations with Foreign Countries (No. 102/1988), as amended Apr. 19, 1990; the Act on Enterprises With Foreign Participation (No. 173/1988), as amended Apr. 19, 1990; and the Act on Corporations of Apr. 18, 1990.

the enterprise is intended to engage in external trade is registration with the Ministry for International Economic Relations also required.⁸

4. *Poland*

In Poland, a Joint Venture Act⁹ was enacted in 1989 and entered into force on January 1, 1990. A foreign participant is required to invest a minimum of 20 percent of the equity in a joint venture, but there is no limit on the maximum percentage of foreign equity investment. Therefore, the foreign investor may hold a majority interest in the venture. The joint venture vehicle must be a corporation or a limited liability company; partnerships are not available for foreign investment.¹⁰ To establish a joint venture, the parties must obtain a permit from the Foreign Investment Agency before they may apply for registration of the joint venture company in the commercial register, which is administered by the court of general jurisdiction. In individual cases the agency may make the permit contingent on there being a minimum percentage of domestic participation. Under a new Joint Venture Law that was passed in June 1991 and that will become effective shortly, the general requirement to obtain permission from the agency will be abolished.

5. *Romania*

The establishment of a company in Romania, which is possible without the involvement of domestic investors, requires registration of an application with the Romanian Development Agency. If no reply is received within one month, the application will be considered approved and the investor may proceed with the investment under the terms and conditions set forth in the application.¹¹

III. Joint Venture Income Taxation in Eastern European Countries

A. DOMESTIC TAXATION

1. *Bulgaria*

Bulgaria generally taxes corporate income at a flat rate of 40 percent. However, companies with a foreign participation exceeding both 49 percent of the equity capital and a net worth of U.S. \$100,000 or its equivalent in convertible

8. The primary legislative instruments providing the bases for business activities of foreigners and joint ventures are Act No. VI/1988 on Business Companies and Act No. XXIV/1988 on the Investment of Foreigners, as amended by Act No. XCVIII/1990.

9. Act on Economic Activity with the Participation of Foreign Parties (No. 74, item 442/1989).

10. Zbigniew M. Slupinski, *Summary of Joint Venture Legislation in Poland*, 18 INT'L BUS. LAW. 401, 402 (1990).

11. A new Foreign Investment Law so providing was passed and promulgated in April 1991. See also Steven M. Glick, *Romania's Foreign Investment Law*, 19 INT'L BUS. LAW. 295 (1991).

currency enjoy a preferential rate of 30 percent. Irrespective of the place of operation or the percentage and amount of foreign investment involved, a particular participation privilege is available that reduces the tax rate on dividend income received by a joint venture to 10 percent. However, this will usually not assume importance as joint ventures rarely receive dividends. In addition, Bulgaria favors corporations operating in free trade zones;¹² such entities enjoy a complete income tax exemption during the first five years of operation, followed by a reduced rate of 20 percent.

2. *Czechoslovakia*

In Czechoslovakia, the rate at which the income of a joint venture is taxed varies with the foreign investor's stake in the venture. Preferential treatment is accorded only to enterprises with a foreign participation in excess of 30 percent. If this requirement is met, a tax of 20 percent on the first Kcs 200,000 of income, increasing to 40 percent on any income in excess thereof, is imposed. If the foreign participation is 30 percent or less, the entity is put on par with all other Czech companies, which are subject to a tax of 20 percent on the first Kcs 200,000 of annual taxable income and a tax of 55 percent on any taxable income in excess of Kcs 200,000. The Ministry of Finance may reduce or completely waive income taxation for a period of up to two years starting with the inception of operations.

3. *Hungary*

Hungary's revised provisions on income taxation became effective January 1, 1991.¹³ Compared with the previous legislation they represent a change for the worse in many respects. For example, the preexisting two-tiered rates of 35 percent applicable to the first three million forints of income and 40 percent applicable to any income in excess thereof have given way to a general flat rate of 40 percent. Also, preferential treatment of foreign investment was reduced. However, some advantages for major investments in the manufacturing sector of the economy remain in effect. If the foreign participation in the joint venture reaches a minimum of 30 percent with an initial equity contribution in the amount of at least Ft 50 million, the income tax is reduced to 16 percent during the first five years and to 24 percent between the sixth and the tenth year of operation. The same applies with regard to profits derived from the operation of hotels constructed by the venture. Tax holidays of five years with a preferential income tax rate of 16 percent between the sixth and tenth year of operation are granted if an investment in a "very important" manufacturing sector, such as the automotive industry, meets the above requirements.

12. Such companies are required to conduct their entire business in hard currency.

13. Profit Taxation Act (IX/1988), as amended (XCIX/1990). The new provisions also affect to some extent joint ventures set up before 1991.

4. *Poland*

In Poland, corporate taxes are generally assessed at a rate of 40 percent. However, joint venture companies are exempt from corporate tax altogether for a period of three years. These tax holidays may be extended for an additional three years if the enterprise is operating in a preferred sector, such as production of housing materials, electronics, communications, transportation, or tourism.¹⁴ Yet, under a new joint venture law that was passed in June 1991, tax holidays will no longer be granted on a general basis.

5. *Romania*

Romania currently imposes income tax at a 30 percent rate on joint venture profits. Romania allows tax holidays for the first two to five years of operation depending on the industrial factor in which the investment is made. In addition, a reduction of the regular income tax rate will be granted after the expiration of the initial tax holidays. The reduction will be 50 percent for profits that are reinvested in certain key industries in Romania and 25 percent for profits that are generated from certain qualifying operations (for example, at least 50 percent of the products and services are exported, more than 10 percent of the expenditures are invested in research and development, and the like).¹⁵

B. CAPITAL GAINS

Few of the tax laws of the Eastern European countries surveyed explicitly provide for the taxation of capital gains realized by the foreign investor upon the sale or other disposition of shares in a wholly owned or a joint venture company. Countries with no pertinent provisions will presumably apply their regular income tax regime with respect to such capital gains in cases where there is no tax treaty assigning the exclusive right to tax capital gains to the shareholder's country. Czech tax authorities, for instance, take the position that capital gain realized upon the alienation of an interest in a Czech company owned by a foreigner is subject to the above-mentioned two-tiered rate of 20-40 percent plus an additional 25 percent withholding tax upon the transfer of the proceeds if no tax treaty is applicable.

C. WITHHOLDING TAXES

Nontreaty withholding tax rates as currently applicable in Eastern European countries for dividend, interest, and royalty payments are set forth in Table 1. Table 2 shows treaty withholding tax rates for payments to U.S. investors.

14. Slupinski, *supra* note 10.

15. Steven M. Glick, *Romania's Foreign Investment Law*, 19 INT'L BUS. LAW. 295, 295-96 (1991).

TABLE 1
DOMESTIC LAW WITHHOLDING TAX RATES CURRENTLY
APPLICABLE IN EASTERN EUROPEAN COUNTRIES

	Dividends	Interest	Royalties
Bulgaria	10%	15%	15%
Czechoslovakia	25%	25%	25/30% ¹
Hungary	0%	0%	20%
Poland	30%	30%	30%
Romania ²	10%	15%	25%

¹The reduced rate applies to industrial and know-how royalties.

²New legislation is about to be adopted.

TABLE 2
WITHHOLDING TAX RATES FOR DIVIDENDS, INTEREST, AND ROYALTIES
PAID BY AN EASTERN EUROPEAN SUBSIDIARY TO A U.S. CORPORATION

	Dividends	Interest	Royalties
Bulgaria ¹	10%	15%	15%
Czechoslovakia	25%	25%	30%
Hungary	5/15% ²	0%	0%
Poland	5/15% ³	0%	10%
Romania	10%	10%	10/15% ⁴

¹No treaty is in effect, but negotiations have been initiated.

²No withholding tax is imposed under domestic Hungarian law at the moment. The reduced rate under the treaty would apply if the beneficial owner is a company owning at least 10 percent of the voting stock of the payor.

³The reduced rate applies if the recipient is a company directly holding 10 percent or more of the payor's voting stock.

⁴Copyright royalties are subject to the reduced rate.

D. ABSENCE OF ANTI-AVOIDANCE PROVISIONS

With respect to antitreaty shopping and other anti-avoidance provisions, as well as measures with the same objective based on internal law (or administrative discretion), the Eastern European authorities, at least for the time being, do not appear to be concerned about the underlying problem, and it may take some time for such concern to develop. This situation can largely be attributed to the strong interest in attracting western business investment and adopting more liberal attitudes toward dealings with the west in general. These factors make the invoking of any kind of sophisticated anti-avoidance tax provisions seem unlikely in the near future.¹⁶

16. Chrysses Demetriades, *Doing Business with Eastern Europe Through Cyprus Double Tax Treaties*, TAX PLAN. INT'L REV., Sept. 1990, at 16, 17.

IV. Taxation of Corporations and Holding Companies in Austria

A. TYPES OF CORPORATIONS

Austrian law recognizes two types of legal entities similar to the corporation of the U.S. legal system, namely the publicly held corporation (Aktiengesellschaft or AG) and the limited liability company (Gesellschaft mit beschränkter Haftung or GmbH), which must have a minimum stated share capital of S 1,000,000 and S 500,000, respectively. The GmbH may be preferable for use as a holding company since, unlike an AG, normally no supervisory board needs to be established and its annual financial statements need not be audited.¹⁷ In addition, the cost of incorporation and legal maintenance tend to be smaller in the case of a GmbH.¹⁸

B. CORPORATE INCOME TAXATION IN GENERAL

In general, the Corporation Tax Code 1988¹⁹ provides for a flat rate of 30 percent of the taxable income of both an AG and a GmbH (both types of companies will hereinafter be referred to as corporations). In addition, a trade tax of about 13 percent is imposed on taxable income. This tax, however, is deductible for corporate income tax purposes, so that the aggregate tax on corporate earnings is roughly 39 percent.²⁰

Interest and royalty income of an Austrian corporation are taxable at the above mentioned total rate of 39 percent. Usually, however, most of such income is channelled through a holding company that pays interest or royalties to the U.S. parent corporation. In this case, the overall Austrian tax burden would be modest since the interest and royalties paid by the Austrian corporation to its U.S. parent

17. Such requirements would only be imposed, inter alia, if the GmbH has more than fifty shareholders and a stated capital exceeding AS 1 million or if it has on average more than 300 employees.

18. For both types of companies a 2 percent tax on the amount of equity actually contributed and a 0.55 percent incorporation fee based on stated capital have to be paid. However, of the minimum capital of AS 1 million in the case of an AG and AS 500,000 in the case of a GmbH, only one-half has to be contributed initially.

19. CORP. TAX CODE § 22 (1988).

20. Austrian law also imposes a combined property tax (the regular property tax and the so called *Erbschaftsteuer äquivalent*, or inheritance tax equivalent) at a rate of 1.5 percent per year on legal entities, which is not deductible for corporate income tax purposes. The tax base is a special value (*Einheitswert*, or unitary value) assigned to all real and personal property of a corporation by the tax authorities, which in most cases is well below its market value. The base, however, cannot fall below the minimum stated capital. Nevertheless, a pure holding corporation is granted a participation privilege exemption from this tax which is applicable under the same circumstances as in the case of corporate income tax. Valuation Act (*Bewertungsgesetz*) § 63.

corporation would be fully deductible, leaving only a small excess of interest and royalties received over interest and royalties paid subject to Austrian corporate tax.

C. HOLDING COMPANIES IN AUSTRIA

No special tax rules govern holding companies. The domestic as well as the international participation privilege exempting dividends and capital gains from corporate tax at the level of the recipient apply to every corporation. The domestic participation privilege exemption is unconditional; the international one is only granted under certain circumstances.²¹ The requirements for the latter exemption are:

- (a) At least 25 percent of the entire share capital (not of the voting power) of a foreign affiliate must be directly owned. The law contains no requirement that the affiliate be "active," or, as for example in the case of the Dutch participation exemption, that it be subject to "a comparable tax regime."
- (b) The affiliate has to be comparable to a corporation under Austrian law.
- (c) No more than 25 percent of the earnings of the affiliate may be derived from debt securities (bonds, debentures, municipal bonds, and similar obligations) and equity in another affiliate if more than 25 percent of the earnings of the other affiliate are derived from such debt securities, unless the first-tier affiliate is a bank.²²
- (d) The participation has to be held without interruption for a minimum period of twelve months prior to the end of the fiscal year in which the dividend from the affiliate is received.²³

Under Austrian law, unlike the rule in some other jurisdictions having a participation privilege exemption, losses on the value of the participation can be deducted.²⁴ They may be offset against any other taxable income of the holding company or carried forward for a period of up to seven years.²⁵ Expenses relating to the acquisition of the participation, such as interest on bank loans, are not

21. CORP. TAX CODE §§ 7(4), 10(5) (as amended, 1989). The trade tax is treated similarly.

22. This seems to be a reasonable interpretation of the statute in light of the legislative history. Case law on this point does not yet exist. The literal translation of the statutory language would read: "The business purpose of the foreign subsidiary may not comprise to an extent exceeding 25% the management of securities (bonds, debentures, municipal bonds and similar obligations) as well as of equity participations in a subsidiary having such business purpose unless it is a bank."

23. CORP. TAX CODE § 10(5) (as amended, 1989).

24. See INCOME TAX CODE § 6(2)(9) (1988) (stating the so-called *gemildertes Niederstwertprinzip*, or moderated lowest value principal). This deduction holds even for unrealized losses (measured by comparison of book and fair market value) if reflected on the balance sheet by a corresponding write-down. Austrian accounting principles mandate such write-downs under certain circumstances. In all other cases they are optional.

25. A loss carryback is unknown in Austrian law.

deductible. The privilege covers not only actual and presumed dividends paid by the subsidiary, but also capital gains resulting from the sale of the participation if effected after the date on which the requirements for the exemption were first met. Thus, the privilege is available for a sale of a qualifying (25 percent) participation if at the end of the fiscal year preceding the sale such participation has been held for at least twelve months without interruption. However, losses on the participation deducted in prior years are recaptured²⁶ by being included in taxable income when the participation is sold. The holding company is not prevented from conducting an active business, in contrast, for example, to the requirement applicable to Swiss holding companies. Nor is there a penalty tax or any other fiscal disadvantage associated with the accumulation of earnings similar to the accumulated earnings tax in the United States.

D. TREATY NETWORK WITH EASTERN EUROPEAN COUNTRIES

Austria is the only member country in the Organization for Economic Cooperation and Development (OECD) that has entered into tax treaties with all Eastern European countries. Table 3 indicates the treaty rates of withholding taxes currently imposed in the Eastern European countries on dividends, interest, and royalties paid to an Austrian holding company. None of the treaties has any anti-avoidance or anti-treaty shopping provisions, except that the treaties with Czechoslovakia, Hungary, Poland, and Romania contain general clauses precluding withholding tax reductions to the extent that interest and royalties exceed an arm's length level. In particular, no treaty contains antitreaty shopping clauses restricting treaty benefits to entities beneficially owned by local residents similar to those found in many newer tax treaties.

TABLE 3
WITHHOLDING TAX RATES FOR DIVIDENDS, INTEREST, AND ROYALTIES
PAID BY AN EASTERN EUROPEAN SUBSIDIARY TO AN AUSTRIAN COMPANY

	Dividends	Interest	Royalties
Bulgaria	0%	0%	0%
Czechoslovakia	10%	0%	0/5% ¹
Hungary	10% ²	0%	0%
Poland	10%	0%	0%
Romania	15%	10%	10%

¹Five percent withholding tax for industrial and know-how royalties.

²At present no withholding tax is imposed under domestic Hungarian law.

26. CORP. TAX CODE § 10(5) (as amended, 1989).

In some respects the treaty with Bulgaria does not follow the OECD model; its effect, however, is in most instances the same. For example, the definition of royalties is narrower, which may seem disadvantageous in light of the exemption from withholding tax applicable to royalties, but royalties that are not covered by the royalty provision are exempted from Bulgarian tax in any event. Royalties fall within the definition of those business profits that are generally exempt from tax in the source country if they are not attributable to a permanent establishment maintained there by the taxpayer.²⁷

E. NO AUSTRIAN ANTI-AVOIDANCE PROVISIONS

Austrian domestic law itself does not contain any provisions designed to counter treaty shopping; nor is there any anti-avoidance legislation directed against conduit companies.²⁸ The Federal Tax Code contains only general anti-abuse clauses.²⁹ But even in this respect there is virtually no risk that these provisions will be invoked in connection with an interposed holding company since their application would simply result in disregarding the Austrian holding company as a conduit or a sham, which would leave Austria with no tax claim at all. By the same token, denial of deductions for what purports to be interest on a debt owed by an Austrian corporation to a controlling shareholder on the basis of notions of thin capitalization or excessive debt-equity ratios are unknown to Austrian statutory law. However, the anti-abuse provisions could be invoked to achieve this result. Austrian practitioners often recommend that the debt-equity ratio not exceed 15 to 1 in order to effectively immunize against attack on thin capitalization grounds.

F. UNITED STATES-AUSTRIAN TAX TREATY

Under the United States-Austrian tax treaty, a 5 percent withholding tax is imposed upon the distribution of dividends by an Austrian holding company to a U.S. investor, assuming that the investor's direct or indirect share in the entire voting stock of the Austrian holding company is at least 95 percent. In addition, no more than 25 percent of the gross income of the payor may be derived from interest and dividends unless such interest or dividends are received from lower-

27. ALFRED PHILLIP, HELMUT LOUKOTA, ROBERT POLLAK, *INTERNATIONALES STEUERRECHT* BG11 (2d ed.).

28. Reiter, *Report from Austria* 47, in KLUWER LAW AND TAXATION PUBLISHERS, *TREATY SHOPPING* (1989).

29. FEDERAL TAX CODE §§ 22-23 (1961). Section 22 reads: "(1) A valid tax claim cannot be avoided or reduced by an abuse of forms or concepts of the civil law. (2) Where such abuse occurs, taxes become payable according to the ordinary rules." Section 23 reads: "Fictitious activities are ignored for the tax claim. If a fictitious transaction conceals another transaction, the concealed transaction is decisive for the tax claim."

tier subsidiaries.³⁰ Capital gains upon the disposition of the holding company shares are not taxable in Austria provided that the shares are owned by a U.S. enterprise and not an individual.³¹ Under articles VII and VIII of the tax treaty Austria has waived the right to levy any withholding tax on interest and royalty payments if the U.S. recipient has no permanent establishment in Austria.³²

V. Comparison Between Austria and Certain Other Holding Company Countries

A number of countries other than Austria have frequently been selected as the domicile for a foreign holding company. Therefore, it is useful to compare the advantages of Austria as a domicile for a holding company for direct investments in Eastern Europe with the situations in Switzerland, the Netherlands, and Cyprus. Other European countries, such as Liechtenstein, Luxembourg, or the Channel Islands, which are occasionally selected as the domicile of a holding company, are not dealt with here because of the lack of tax treaty networks between such countries and Eastern European countries.

A. SWITZERLAND

Switzerland offers, apart from relatively low corporate tax rates in general, the possibility of establishing holding, as well as so-called domiciliary, companies both of which enjoy preferential treatment under cantonal tax laws. Generally speaking, a company has to hold substantial investments in the equity capital of other companies on a long-term basis and dividends derived from such investments must constitute its principal form of income in order to qualify for holding company status. The prescribed ratios of equity participation to other assets and dividend to other income, including interest and royalty income, vary from canton to canton. If the required criteria are met, most cantons grant a total exemption from cantonal and communal taxes. If a company does not qualify for holding company status, it may be treated as a domiciliary company, provided it is not engaged in active business in Switzerland and does not hold title to Swiss real estate. In most cantons, either a domiciliary company is entirely exempt from income tax or a reduced rate may be negotiated with the competent tax authorities.

30. Convention for the Avoidance of Double Taxation with Respect to Taxes on Income, Oct. 25, 1956, U.S.-Aus., art. VI, 8 U.S.T. 1699. In all other cases the rate is 12.5 percent, which is 50 percent of the rate applicable under internal Austrian law. As an anti-avoidance measure, the normal rate will also be imposed if the relationship of the two companies is found to be arranged or maintained primarily with the intention of securing the reduced rate. *Id.*

31. *Id.* art. III.

32. Losses resulting from the holding company's receiving lower interest or royalty payments from the operating subsidiary than those received by the U.S. investing company will not be recognized. *See id.* arts. VII-VIII. This is an unchallenged administrative practice. *See also* GERMAN INCOME TAX CODE § 34(c), which so provides explicitly.

Federal tax law recognizes neither holding nor domiciliary status as such. However, under the Swiss participation privilege exemption, dividend income is exempt from federal income taxation in general if the related investment represents at least 20 percent of the affiliate's share capital or has a minimum book value of two million Swiss francs.

Although Swiss holding and domiciliary companies might be thought of as attractive offshore vehicles for the purpose of investing in Eastern Europe, the tax treaty network between Switzerland and Eastern European countries is limited. Besides a treaty with the former Soviet Union, only treaties with Hungary and Romania exist. But they do not confer advantages with respect to applicable withholding tax rates as compared to the withholding tax rates applicable under the national tax laws of these countries. A tax treaty with Czechoslovakia is currently contemplated, but it is still unclear whether and when it will be signed. The tax treaty between the United States and Switzerland provides for withholding tax rates on dividends of 5 or 15 percent as in the case of Austria. Swiss law does not impose withholding tax on the payment of interest and royalties.

Unlike the situation in the case of Austria, tax planners have to be wary of particular anti-avoidance legislation³³ if the routing of an investment via Switzerland is contemplated. The general thrust of the legislation in question is that the reduction or waiver of withholding taxes (tax benefit) provided for under Swiss tax treaties shall not benefit persons who, although by the letter of the treaty entitled to a tax benefit, are thought to claim such tax relief abusively. A tax benefit is, deemed to be claimed abusively if, among other things, it relates to income a substantial part of which is directly or indirectly used to satisfy the claims of persons not entitled to the treaty benefits. This covers, in particular, interest and royalty conduit arrangements, such as a holding company that uses a substantial part (more than one half) of its foreign source income, in respect of which a treaty tax benefit is claimed, to pay debt interest or royalties to its shareholder, which, in turn, is not entitled to benefits under the treaty concerned. A tax benefit is also regarded as claimed abusively if it relates to income that benefits a legal person residing in Switzerland that does not make appropriate profit distributions and in which persons not entitled to the treaty benefits hold, directly or indirectly, a substantial equity participation or are otherwise interested.³⁴

B. THE NETHERLANDS

Dutch law provides for a participation privilege exemption comparable to that accorded under Austrian law. The privilege is available under Dutch statutory law, but in cases involving any unusual features the taxpayer ordinarily applies

33. Decree of the Federal Council Concerning Measures Against the Improper Use of Tax Conventions Concluded by the Swiss Confederation on Dec. 14, 1962.

34. De Coulon, *Report from Switzerland* 261, in KLUWER, *supra* note 28.

for a ruling from the Dutch tax authorities. Some notable differences between the Austrian and Dutch participation privilege exemption are:³⁵

- (a) Under the Dutch privilege the parent company's stake in the affiliate needs to be only 5 percent.
- (b) Unlike in Austria, the passive nature of the holding company may jeopardize the exemption of dividend income from Dutch income tax. In some cases, for example, a positive ruling might be conditioned on the holding company's performance of at least some activities. If the Dutch holding company is passive and, at the same time, is a subsidiary of an active foreign company and holds a participation of less than 50 percent in the operating subsidiary, an exemption privilege ruling is not likely to be granted.
- (c) Unlike in Austria, losses incurred on the sale or disposition of shares of affiliates to which the participation exemption applies are not deductible. Losses are deductible only if they are realized upon liquidation of the subsidiary and if certain conditions are met. The main requirement for the deductibility of liquidation losses is that the Dutch parent company have had a participation of at least 25 percent in the foreign affiliate concerned during a minimum period of five years prior to the liquidation.
- (d) The nonresident affiliate has to be subject to a "comparable tax regime"—some sort of income tax—in its country of domicile. However, being subject to an income tax regime in principle suffices so that, for instance, even a tax holiday of up to ten years would not preclude application of the participation exemption.
- (e) Interest and royalty payments funnelled through to the investor are likely to be subject to a higher tax burden in the Netherlands than in Austria. The Dutch tax authorities require that certain minimum percentages of the gross interest and royalty receipts of a holding company be taxable,³⁶ whereas no such requirement is imposed in Austria—a disadvantage that, like the restrictions mentioned above under (b) and (c), might be significant depending on the particular nature of the investment.

Dutch corporate income tax is imposed at a rate of 40 percent decreasing to 35 percent for amounts exceeding 250,000 guilder compared to a maximum tax of about 39 percent in Austria. Neither country withholds tax on interest or royalties paid to a U.S. investor. As in the case of Austria, dividends paid by a wholly owned Dutch holding company to its U.S. parent corporation are subject to a withholding tax of 5 percent.³⁷

35. Janbert L.D. Burggraaf, *Participation Exemption in The Netherlands*, TAX PLAN. INT'L REV., Jan. 1991, at 20.

36. Janbert L.D. Burggraaf, *Niederländische Holdinggesellschaften*, in WIRTSCHAFTSRECHTLICHE BLÄTTER 133, 135 (1989).

37. The reduced rate is available if, during that part of the payor's taxable year which precedes the date of payment and the whole prior taxable year (if any), the recipient owns at least 25 percent of the payor's voting stock (alone or together with another United States recipient, provided each VOL. 26, NO. 2

TABLE 4
WITHHOLDING TAX RATES FOR DIVIDENDS, INTEREST,
AND ROYALTIES PAID BY AN EASTERN EUROPEAN SUBSIDIARY
TO A DUTCH HOLDING COMPANY

	Dividends	Interest	Royalties
Bulgaria ¹	10%	15%	15%
Czechoslovakia	0/10% ²	0%	5%
Hungary	5/15% ³	0%	0%
Poland	0/15% ⁴	0%	0/10% ⁵
Romania	10/15% ⁴	0/10% ⁶	10%

¹No treaty is in effect.

²No withholding if the resident holds at least 25 percent of payor's capital.

³The reduced rate applies if the beneficial owner is a company holding directly at least 25 percent of the payor's capital.

⁴No withholding if the beneficial owner is a company holding directly at least 25 percent of the payor's capital.

⁵No withholding in case of copyright royalties.

⁶No withholding if paid to a bank or other financial institution or in connection with a loan granted or guaranteed by the other state of one of its institutions.

TABLE 5
WITHHOLDING TAX RATES FOR DIVIDENDS, INTEREST, AND ROYALTIES
PAID BY AN EASTERN EUROPEAN AFFILIATE TO A CYPRUS COMPANY

	Dividends	Interest	Royalties
Bulgaria	0%	0%	0%
Czechoslovakia	10%	10%	0/5% ¹
Hungary	0%	0%	0%
Poland ²	30%	30%	30%
Romania	10%	10%	5%

¹Five percent withholding tax for industrial and know-how royalties.

²No treaty is in effect.

C. CYPRUS

Cyprus permits the establishment of special offshore holding companies.³⁸ Such a company may have nonresident shareholders only, and its business purposes and activities must be wholly restricted to operating and holding investments in companies domiciled outside the country. If these criteria are met, the company enjoys a reduced rate of tax of 4.25 percent on its net profits—a fact

does not own less than 10 percent). In addition, only 25 percent of the payor's gross income may consist of interest and dividends other than interest and dividends received from 50 percent-owned subsidiaries and interest derived in a banking, insurance or financing business. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, July 23, 1982, U.S.-The Netherlands, art. VII, T.I.A.S. 10772, at 15.

38. Demetriades, *supra* note 16.

that might prove advantageous, for example, if interest or royalties are to be earned by the holding company and eventually distributed as dividends to a U.S. parent corporation. Domestic legislation provides for no withholding tax on dividends, interest, or royalties.

VI. Foreign Exchange Controls

United States corporations making direct investments in Eastern European countries must be concerned with foreign exchange restrictions that may impede the remittance of dividends, interest, and royalties and the repatriation of invested capital in convertible currency.

A. EASTERN EUROPEAN COUNTRIES

The foreign exchange regimes of the Eastern European countries as presently constituted may entail severe restrictions on the transfer of profits and the repatriation of the invested capital. Although some restrictions might seem unacceptable at the moment, the overall tendency towards liberalization will in all likelihood bring about further relaxation of current regulations.

Currently, Czechoslovakia and Hungary have the most liberal foreign exchange regimes. Profits as well as amounts realized upon the liquidation of an enterprise are transferable without restriction. All other countries in question guarantee foreign joint venture partners at least the unlimited right to transfer their share of after-tax profits that are earned in foreign (hard) currency. In addition, some countries have already introduced "limited internal convertibility," under which part of the domestic currency profits may also be transferred. Poland currently allows for 15 percent of the foreign partner's share of profit from the previous fiscal year generated in zlotys to be exchanged into hard currency and transferred abroad.³⁹ According to the Foreign Trade Ministry, full convertibility will be put into force as early as 1991.⁴⁰ Similarly, Romania permits a portion of leu profits (8 to 15 percent of the foreign investors capital contribution) to be transferred to foreign partners.

B. AUSTRIA

Along with the adoption of a more favorable tax environment for foreign investors, Austria has also completely liberalized its foreign exchange control

39. Treaty with Poland Concerning Business and Economic Relations, S. TREATY DOC. NO. 18, 101st Cong., 2d Sess. 14-15 (1990). This percentage will increase in 1992 to 20 percent, in 1993 to 35 percent, in 1994 to 50 percent, in 1995 to 80 percent, and from 1996 on no restrictions will remain.

40. DIE PRESSE (Vienna), June 18, 1991, at 13.

regime.⁴¹ There remain, as in many other countries, only reporting requirements for the purpose of gathering statistical data.

VII. United States Tax Considerations

The U.S. tax implications of the interposition of a wholly owned Austrian holding company between a U.S. investing corporation and a direct investment in an Eastern European operating company are of central importance in deciding whether to adopt such a structure. Use of a holding company will be warranted only if tax savings can be achieved that clearly outweigh the additional costs and administrative burdens involved in use of a holding company.

A. EFFECT OF ACCUMULATION RATHER THAN DISTRIBUTION OF HOLDING COMPANY INCOME

The interposition of a wholly owned foreign holding company between the U.S. investing corporation and the foreign operating company in which the investment is to be made has certain U.S. tax implications. In many cases the only tax saving that can normally be achieved by accumulating in the holding company dividends, interest, and royalties received from an Eastern European operating company is the 5 percent Austrian withholding tax on dividends paid to a U.S. corporation. This tax is not paid as long as the earnings are accumulated rather than distributed by the holding company.

Because the wholly owned holding company will be a controlled foreign corporation for U.S. tax purposes, the undistributed dividend, interest, and royalty income it receives from the operating company will usually constitute foreign personal holding company income, which will be taxed as a constructive dividend to its U.S. parent corporation.⁴² This constructive dividend will carry with it indirect foreign tax credit for Austrian corporate income tax, if any, and withholding taxes imposed on the income of the holding company, that is, withholding taxes on dividend, interest, and royalty income received from the operating company.⁴³ The saving of the Austrian withholding tax that can be achieved by accumulating rather than distributing the income of the holding company will be significant by itself if that tax cannot be credited because it would exceed the applicable limitation on the foreign tax credit under section 904 of the Internal Revenue Code (the Code).⁴⁴

41. See, e.g., Exchange Control Regulations of the Austrian National Bank [Devisenrechtliche (DE) Kundmachungen] DE 1/90 - DE 3/90.

42. I.R.C. §§ 954(a)(1), 954(c) (West Supp. 1991).

43. I.R.C. § 960(a) (West 1988).

44. Payment of Austrian withholding tax entitles the parent company to a direct tax credit. I.R.C. § 901 (West Supp. 1991). The foreign tax credit limitation applies to the combined amount of potential direct and indirect foreign tax credits. I.R.C. § 904 (West Supp. 1991).

B. SIGNIFICANCE OF REDUCTIONS IN WITHHOLDING
TAXES IN SOURCE COUNTRY

The most significant potential benefit of the interposed holding company typically lies not in the accumulation in the holding company of dividend and other income received from the operating company. The benefit lies, rather, in the reduction of the foreign withholding taxes on payments of dividends, interest, and royalties by the foreign operating company to the holding company below what these taxes would be if those dividends, interest, and royalties were paid by the operating company directly to the U.S. parent company. These reductions result under the terms of tax treaties between the country in which the holding company is established and the country in which the operating company is established. The treaties typically reduce or eliminate the withholding tax on dividends, interest, and royalties paid by a corporation in one contracting state to a recipient in the other.

The reduction in withholding taxes may be of significance to any U.S. corporation that is in an excess foreign tax credit posture because the foreign tax burden it bears exceeds the applicable foreign tax credit limitations under section 904 of the Code. The use of a holding company can reduce the total foreign tax burden on distributed earnings of the foreign operating company below the level that would be obtained if the earnings were distributed directly by the foreign operating company to the U.S. parent. The reduction will be an absolute saving to the extent that it represents tax that would not otherwise be creditable because it exceeds the applicable section 904 foreign tax credit limitation. The excess foreign tax credit problem can exist on an overall basis because the U.S. corporation's aggregate foreign source income bears too heavy a foreign tax burden or it can exist with respect to a specific investment in a noncontrolling interest in a particular foreign corporation.

C. ALLEVIATION OF OVERALL OR SPECIFIC INVESTMENT
EXCESS FOREIGN TAX CREDITS

The excess foreign tax credit problem can exist because the overall foreign operations of the U.S. corporation generate foreign source income subject to the general foreign tax credit limitation of section 904 (d)(1)(I), and that foreign source income bears a total foreign tax burden that exceeds the maximum U.S. corporate tax on that income, which is here assumed to be 34 percent. This corporation will seek to ameliorate its excess foreign tax credit problem by assuring that general limitation income generated by a direct investment in an Eastern European country will bear a total foreign tax burden of less than 34 percent. If this is not possible, the objective will be to minimize any foreign tax in excess of 34 percent.

The excess foreign tax credit problem can also exist with respect to the dividends generated as a result of the acquisition of any 50 percent or smaller

interest in a foreign corporation (a noncontrolling interest). In this situation, the dividends would be subject to the special section 904 (d)(1)(E) foreign tax credit limitation that applies to dividends from each noncontrolled section 902 corporation. Therefore these dividends could not be blended with any general limitation income (or other foreign source income) for foreign tax credit limitation purposes. In this case, if the foreign tax burden on dividends from the foreign corporation (including corporate income tax and dividend withholding tax) exceeds 34 percent, the excess will be noncreditable. Accordingly, in this situation, if the aggregate foreign tax burden can be reduced by lowering the foreign dividend withholding tax, the interposition of a foreign holding company will produce an absolute savings in tax.⁴⁵

D. APPLICATION OF SECTION 904 (d)(3) LOOK-THROUGH RULES TO CONTROLLING INVESTMENTS

As implied in the preceding paragraph, the U.S. tax picture will differ depending on whether the U.S. corporation is acquiring, through its wholly owned Austrian holding company, an interest of more than 50 percent of the voting power or value of the stock of the Eastern European operating company or an interest of 50 percent or less. If an interest greater than 50 percent is acquired through the interposed holding company, the operating company will be a controlled foreign corporation.⁴⁶ As a result, for purposes of the U.S. foreign tax credit limitations under section 904 of the Code, the look-through rules of section 904(d)(3) will apply to any dividends, interest, and royalties paid by the operating company to the interposed holding company. To the extent that the operating company's income, in turn, consists of operating income (such as income from manufacturing and sales or from performing services) the dividends, interest, and royalties it pays to the holding company will usually be general limitation income subject to the general limitation of section 904(d)(1)(I).

Similarly, payments of dividends, interest, or royalties or any constructive dividends under Subpart F of the Code from the holding company to the U.S. parent corporation will be characterized under the look-through rules as general limitation income. These payments can therefore be blended with other foreign-source general limitation income of the U.S. corporation. Suppose that the reduction in withholding taxes on dividends, interest, and royalties paid by the Eastern European operating company to the foreign holding company brings the total level of foreign tax on the distributed earnings of the operating company to a level that is (i) below the level that would apply if the payments were made directly to the U.S. corporation and (ii) below the 34 percent level of U.S. tax

45. A reduction of the aggregate foreign tax burden below 34 percent would merely shift tax revenues to the United States.

46. Direct, indirect, and constructive ownership must be taken into account in testing whether a foreign corporation is a controlled foreign corporation. I.R.C. §§ 957(a), 958 (West 1988).

on the U.S. corporation's general limitation income. In this case, the reduction will enable the cross-crediting of higher foreign taxes on other general limitation income against the U.S. tax that would otherwise be imposed on the lower-taxed general limitation income from the Eastern European operating company.

Assume, for example, that a U.S. corporation that has excess foreign tax credits associated with its foreign general limitation income acquires through an Austrian holding company a 51 percent interest in a Bulgarian joint venture company operating in a free trade zone. The Bulgarian company enjoys a five-year Bulgarian tax holiday. No foreign tax will be imposed on the holding company because the Austrian-Bulgarian treaty eliminates the Bulgarian withholding tax. However, if the dividends were distributed directly by the Bulgarian company to the U.S. corporation, a 10 percent Bulgarian withholding tax will be imposed. The elimination of the Bulgarian withholding tax on dividends under the Austrian-Bulgarian treaty enables the dividends received through the Austrian holding company, which are general limitation income, to absorb more excess foreign tax credit than could be absorbed if the dividends were paid directly to the U.S. investing corporation.

Even if the reduction in withholding tax does not bring the total level of foreign tax on the distributed earnings of the operating company below 34 percent, the reduction will represent a real savings in the combined U.S. and foreign tax burden whenever the tax reduced would not otherwise be creditable because it would exceed the section 904(d)(1)(I) general limitation. To revert to the example offered at the outset, if a U.S. corporation acquired a 51 percent stock interest in a Czech operating company, the total Czech tax burden on dividends distributed to the U.S. investing corporation (corporate income tax of 40 percent plus a 25 percent dividend withholding tax) would exceed the 34 percent U.S. tax burden on the dividends if received directly by the U.S. corporation. Accordingly, being able to reduce the withholding tax burden from 25 percent to 10 percent by interposing an Austrian holding company will result in a real savings.

E. WITHHOLDING TAX REDUCTIONS ON INTEREST AND ROYALTIES

In the case of interest and royalties paid to the Austrian holding company by an Eastern European operating company, in which the holding company has a controlling interest, overall tax savings may be achieved through reductions in the withholding taxes on such payments in the source country that bring the rates below the maximum U.S. 34 percent.⁴⁷ These payments would normally be deductible by the operating company, and therefore, the only source country tax

47. It is assumed that the withholding taxes on interest and royalties under the Austrian treaty are lower than the rates that apply under the United States treaty with the source country. To the extent that this is not the case, the benefit of channeling interest and royalties through an Austrian holding company will be eliminated.

they would bear would be the withholding tax, if any. To the extent that these payments may be passed on by the holding company as deductible payments of interest and royalties to the U.S. parent corporation, they will be exempt from the corporate income tax in the country in which the holding company is organized. These payments will bear only the withholding tax, if any, that may be imposed under the U.S. tax treaty with the country in which the holding company is established. Under the section 904(d)(3) look-through rules, these payments will often be general limitation income and, as a result of bearing a foreign tax burden that is well below the 34 percent U.S. corporate tax rate, will be useful in absorbing excess foreign tax credits generated by other general limitation income that is subject to a relatively high foreign tax burden. Under current law, for example, interest and royalties paid by an operating company in Czechoslovakia are exempt from Czech withholding tax (or in some cases royalties are subject to a 5 percent withholding tax) if paid to an Austrian company while a 25 or 30 percent withholding tax is applicable if the interest or royalties are paid directly to a U.S. corporation.

F. TREATMENT OF A NONCONTROLLING INVESTMENT

If the U.S. corporation acquires (through an interposed holding company) 50 percent or less of the voting power or the value of the stock of the foreign operating company, the foreign operating company will not be a controlled foreign corporation, and the section 904(d)(3) look-through rules will not apply to the payments of dividends, interest, and royalties it makes to the holding company. As a consequence, interest and royalties will usually be characterized in the hands of the holding company for foreign tax credit limitation purposes as foreign personal holding company income, which is passive income.⁴⁸ To the extent that interest and royalty payments received by the holding company are distributed as actual dividends or deemed distributed as constructive dividends to the U.S. parent, they retain the character of passive income under the section 904(d)(3) look-through rules for foreign tax credit limitation purposes in the hands of the U.S. parent. Hence, this income will usually be subject to the section 904(d)(1)(A) separate foreign tax credit limitation for passive income and cannot be blended with general limitation income.

More importantly, dividends from the noncontrolled operating company are characterized for foreign credit limitation purposes in the hands of the holding company and the U.S. parent as dividends from a noncontrolled section 902 corporation. As noted above, these dividends are subject to the special foreign tax credit limitation under section 904(d)(1)(E) and cannot be blended with any

48. I.R.C. § 904(d)(2)(A)(i) (West Supp. 1991). There are a number of exceptions to this general rule. See, e.g., I.R.C. §§ 954(c)(2)(A), (c)(3)(A)(i)-(ii) (West Supp. 1991).

other foreign source income for foreign tax credit purposes. Accordingly, in this situation, the reduction in the withholding tax can represent a real savings in tax only when the total foreign corporate income and withholding taxes on the dividend exceed the 34 percent U.S. tax on dividends from the foreign operating company.

The reduction in withholding tax may represent an absolute savings with respect to earnings of the noncontrolled joint venture corporation in the Eastern European country distributed as dividends to the Austrian holding corporation and then on to the U.S. investing corporation. It will represent such a savings if the withholding tax in the source country is reduced under the applicable Austrian treaty to a level that is more than five percentage points lower than the rate of withholding tax that would apply to dividends paid by the operating corporation directly to the U.S. investing corporation. In other words, the savings in withholding tax in the source country that is gained by interposing the Austrian holding company must exceed the 5 percent Austrian withholding tax on dividends paid by the Austrian holding company to the U.S. investing corporation, which would not be imposed if the holding company were not interposed.

If earnings are accumulated in the Austrian holding corporation, although they would be deemed distributed as Subpart F constructive dividends to the U.S. parent, the savings will be larger since the Austrian withholding tax will not be incurred.

VIII. Conclusion

A U.S. corporation making a direct investment in an operating company in certain Eastern European countries may achieve significant tax savings by having its investment held by a wholly owned Austrian holding company rather than by holding it directly. These savings result because under current law the withholding taxes on dividends, interest, and royalties paid by an operating company are lower under the Austrian treaties with certain of these countries than the withholding taxes that would apply if the dividends, interest, and royalties were paid directly by the operating company to the U.S. corporation. The potential savings will exist unless and until the United States enters into tax treaties with these countries that reduce the withholding taxes on dividends, interest, and royalties to the levels achieved under the existing Austrian tax treaties with these countries. The reductions in withholding tax on the dividends, interest, and royalties under the holding company structure are more likely to produce benefits if the operating company is a controlled foreign corporation than if it is not, but even if it is not a controlled foreign corporation, the reduction in withholding taxes may represent a significant potential savings.